02

GOVERNANCE AND CSR

THE LINK BETWEEN CORPORATE GOVERNANCE AND CORPORATE SOCIAL RESPONSIBILITY : The role of the Board of Directors

Condensed version of the study

IMS LUXEMBOURG
Inspiring More Sustainability

> "MARKET DISTURBANCES, SOCIAL UNREST, ECOLOGICAL DEVASTATION, NATURAL AND MAN-MADE DISASTERS (WHETHER NEAR OR FAR AWAY) ARE HAVING DIRECT IMPACTS ON SUPPLY CHAINS, CAPITAL FLOWS, PUBLIC OPINION AND EMPLOYEE PRODUCTIVITY."

Ban KI-MOON,
UN Secretary General

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Acknowledgements

This study was made possible through support and collaboration of IMS Luxembourg's Working Group composed of BGL BNP Paribas, ILA, KNEIP, KPMG and PwC.

EDITOR'S NOTE

Diane Muller Kneip

Twenty-first century stakeholders increasingly request businesses to deliver on sustainability, including environmental, social and governance (ESG) elements. In a volatile global environment, the European Commission also consider a growing number of possible legislative frameworks to ensure that European firms are more accountable and transparent to their stakeholders and shareholders. With the objective of helping companies integrate sustainability issues into corporate strategy, IMS Luxembourg partnered with Institut Luxembourgeois des Administrateurs (ILA) to constitute a working group analysing the link between CSR and corporate governance. The working group commissioned the assistance of Patricia Crifo from École Polytechnique of Paris and Univ. Paris West, as well as Antoine Reberioux from University Antille Guyane and Uni. Paris West to conduct a study on the implication the legislative process has on the development of corporate social responsibility policies and practices compared to firms which implement such policies and practices voluntarily in Europe and North America.

Diane Muller Kneip
Executive Director, KNEIP
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INTRODUCTION

This study investigates the relationships between corporate governance and Corporate Social Responsibility (CSR). The underlying intuition is that governance factors are major determinants of CSR policies and extra-financial performance: the structure of equity ownership together with shareholder propensity towards CSR, the composition and structure of the board of directors together with Board propensity towards CSR, and the regulatory framework on corporate governance and CSR. We show how evolutions regarding corporate governance over the three previous decades have paved the way and shaped the rise of CSR. In addition, we elaborate a typology of CSR and governance structures that characterize OECD countries depending on whether the CSR reporting regime is stringent versus non-stringent, and on whether the corporate governance model is based on the shareholder, stakeholder or hybrid regime.

CSR aligns corporate activities with the deepest values of the corporate stakeholders.

CORPORATE SOCIAL RESPONSIBILITY

- is defined by the EU commission as the responsibility of enterprises for their impacts on society.

CORPORATE GOVERNANCE

- refers to the set of (formal and informal) rules and structures that shape managerial decisions and accountability.

CORPORATE GOVERNANCE MODELS

FRIEDMAN (1970) VS FREEMAN (1984) DEBATE

FRIEDMAN (1970)

- "There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say engages in open and free competition without deception or fraud"
- *Milton Friedman New York Times Magazine (1970)*

FREEMAN (1984)

- " Every business creates, and sometimes destroys, value for customers, suppliers, employees, communities and financiers. The idea that business is about maximizing profits for shareholders is outdated and doesn't work".
- *R. Edward Freeman Stakeholder Theory*

SHAREHOLDER MODEL VS STAKEHOLDER MODEL

The purpose of modern business firms has brought about two competing theories. Each of these theories creates a framework that engages environmental and social performace, as well as governance.

SHAREHOLDER MODEL	a company should be run for the sole interest of its shareholders. The notion of corporate governance lies intrinsically in the separation between owners (of capital) and managers and the conflict of interest between them.
STAKEHOLDER MODEL	relies on the idea that if the firm should respect the interests of its shareholders, it also represents broader social interests that must be taken into account as much as those of capital providers.

Below is a table that we have created to demonstrate the difference in characteristics of the shareholder model compared to stakeholder models of governance:

	Shareholder	Stakeholder
Objective	Shareholder value	Stakeholder value
Financial Markets	Very active	Limited
Shareholding	Dispersed	Concentrated, blockholders
Discipline device and control	External Market-based (eg. takeover bids threats)	Internal Monitoring (eg. audit)
Incentives and horizon	Short term (objectives based on stock prices) High powered financial incentives	Long term (objectives based on strategic management) Low powered financial incentives
Boards	Represent shareholders interests	Dominated by stakeholders

OWNERSHIP, BOARD COMPOSITION & CSR

> IF CEOs ARE DETERMINED TO EMBED SUSTAINABILITY AS A MAINSTREAM PRACTICE THEY WILL NEED THE ENGAGEMENT OF THE BOARD[1]

- The board of directors (or the Supervisory Board) is a central mechanism in the implementation of any credible CSR investment[1].

- The sensitivity or mind-set of board members is critical when it comes to the development of CSR-oriented strategies. This sensitivity is related to observable individuals or collective attributes, such as independence, expertise or diversity.

- Recruiting female directors and directors from ethnic minorities can bring about diversity in ideas and opinions at the board level, generating stronger orientation towards CSR activities. Moreover, boards of diverse backgrounds can help provide better relationships with stakeholders. Put simply, more diversity at the board level is likely to favor broad mind-set regarding the impact of economic activities on remote stakeholders.

- Beyond independence or diversity, a simple way to increase board involvement in CSR initiatives and policies is to structure the board so that a subset of the board is directly in charge of topics related to CSR, similar to an Audit Committee's responsibility for the role of internal audit.

[1] *Moving Upwards : The Involvement of the Boards of Directors in the UN Global Compact, 2010 p.4*

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BOARD DIVERSITY & COMPETENCY CASE STUDY - NOVO NORDISK

Novo Nordisk has been a leader in corporate sustainability for their ability to integrate the Triple Bottom Line Principle (people, planet and profit) into their global business model. This Denmark based company has been revolutionizing diabetic care around the globe for over 90 years.

BOARD DIVERSITY AT NOVO NORDISK

Novo Nordisk is an international publicly traded company on both the Copenhagen and New York stock exchanges. Therefore, the company is required to meet certain corporate governance obligations, which are outlined by the Danish Corporate Governance Recommendations designated by NASDAQ OMX Copenhagen and the Corporate Governance Listing Standards of the New York Stock Exchange. Both compliance standards have included mechanisms to ensure that companies like Novo Nordisk encompass board diversity. For Novo Nordisk, having a diverse board is more than just meeting its legal obligations. Diversity is important to the company at the board level because it allows for discussions and decisions to be made that are reflective of the multifaceted environment in which they operate.

The term diversity is no longer limited to race, gender or age. It can also include personal and professional experiences. With this in mind, Novo Nordisk has comprised its board to include more independent directors than dependent directors. The shareholders of the company are responsibile for electing six independent directors, and one dependent. The one dependent director is the Chief Executive Officer of the Novo A/S, which is a limited liability company owned by the Novo Nordisk Foundation. The company's Danish employees elect the remaining four members of the board. These dependent directors are able to provide to the independent directors an "on the ground" perspective of what policies and practices are effective and efficient to the business.

The healthcare industry requires Novo Nordisk to constantly be aware and be able to respond to the rapid changes in innovation, technology, as well as research and development. According to the company's Competence Profile of the Board of Directors, a person who has reached the age of 70 or has served on the board for more than 12 years at the time of the General Meeting, can no longer be elected or re-elected to the company's board. While this is not contradictory to the company's position on age discrimination, it provides them with the opportunity to receive fresh ideas, and a different perspective on the events that occur in their industry.

Nationality is also a key component of board diversity for Novo Nordisk. Currently, the company's board has a representation of five nationalities. It is the Boards goal by 2017, to include at least two shareholder elected members with Danish nationality, and at least two shareholder elected members of other nationalities.

Novo Nordisk recognizes that their board and senior managment should be more reflective of the overall gender composition of the company. To address this issue at the board level, the Board aspires to include at least two women shareholder-elected directors by 2017. Presently, the Board has one woman as a shareholder-elected director and employee-elected director.

" THE COMPANY'S BOARD OF DIRECTORS CAN ONLY FULFILL ITS ROLE TODAY BY WORKING WITH A BOARD AGENDA COVERING ISSUES WHICH ARE DRIVEN BY THE COMPANY'S MANY STAKEHOLDERS . "

Mads Ovlisen, Chairman, Novo Nordisk A/S

CSR & FINANCIAL PERFORMANCE

The rise of CSR consideration in business conduct has led OECD countries to regulate on this topic, mostly through extra-financial reporting. There are three methodologies used to examine the link between environmental and social responsibility and firm performance:

- Event Studies – examines the effect of new information on stock returns, considering that any information whether environmental or social management should be reflected in how market analysts assess the financial performance of a firm.

- Best-in-class studies versus Worst-in-Class studies – compares the portfolio performance of firms considered as the most responsible, compared to that of irresponsible firms.

- Regression Studies (econometric estimations on large sample) – relies on the environmental and social ratings (specialist ESG from rating agencies such as KLD in the US or Vigeo in Europe) or on qualitative data (like emission data corruption, rewards policy etc.) to measure environmental and social performance and test its impact on firm performance.

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SAVING MONEY & INCREASING PROFITS CASE STUDY - MARKS & SPENCER

MARKS & SPENCER

Marks & Spencer (M&S) founded in 1884 has become one of Britain's largest global retail chains. Over the last 120 years, M&S has expanded from a single market stall to a one-stop shopping experience, with 20 million customers visiting their more than 1000 stores weekly, 2,000 vendors that supply products for their stores' shelves and over 80,000 employees worldwide (Kaye. 2013). M&S provides its customers with the convenience of having everything at their fingertips from clothes, furniture, and high-quality food products to flowers.

The company continues to demonstrate that doing "good" sells and saves money. Over the last three years, the company's sustainability initiative, Plan A, has generated an additional £30-35 million in revenue for their business (M&S Annual Report, 2013). This sustainability strategy has also racked up £135m worth of savings for the company over the past year (Nicholas. 2013).

Plan A launched in 2007 covers 180 commitments that the company plans to achieve by 2015. Plan A is based on 5 themes: climate change, waste, sustainable raw materials, fair partnerships and health.

After three years, M&S began to see the financial benefits of their multi-million pound investment. M&S saw their sustainability intiatives, Plan A as a long-term investment, even when analysts stated that they should do away with the project.

> "PLAN A HAS BEEN ENORMOUSLY POWERFUL TO LINK TOGETHER RELATIVELY SMALL SUMS OF MONEY THAT WE SAVE IN MANY DIFFERENT STORES, PRODUCTS AND SUPPLY CHAINS."

Mike Barry, Head of Sustainable Business, M&S

CSR REPORTING

- In recent years, an increasing number of national legislations have made CSR reporting mandatory for large firms.

- Some countries have adopted “comply or explain” regulations, while others have implemented outright and prescriptive legal requirements.

- Some countries focus their disclosure requirements on large companies, while others target listed or state-owned firms.

- Only 2500 out of the 42000 European large companies formally disclose extra-financial information on a yearly basis.

- There is wide heterogeneity in the quality of extra-financial information that is disclosed, making it difficult for stakeholders to correctly evaluate the firm’s environmental and social performance.

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THE EVOLUTION OF CSR REPORTING CASE STUDY - BNP PARIBAS

The BNP Paribas Group is the product of a rich history of successful bank mergers and acquisitions that dates back to the 19th century. With the merger of Banque Nationale de Paribas (BNP) and Banque de Paris et des Pays-Bas (Paribas) in 2000, BNP Paribas became one of the largest banking institutions in Europe.

While continuing to be aligned with the four core values of BNP Paribas – Responsiveness, Creativity, Commitment and Ambition, over the last 13 years the Group has evolved in the sustainability reporting. Through the years, BNP Paribas has become more specific in communicating their social, environmental and governance performance through reporting. In 2000, published a Social Report, which discussed the Group's contributions to the development of their employees, as well as the impact that the have made to the entire Group. In 2003, the Group began to discuss their environmental and sustainability benchmarks and performance through their Annual Report as well as in a separate Sustainability Report, and still published their Social Report. Also, during that year, the company joined the UN Global Compact. Endorsed by the Chairman and CEO at the time, the Group implemented specific sustainability guidelines based on the principles of the UN program. In 2005, they shifted their focus to corporate social responsibility, and co-ordinated their activities through the Group's Sustainable Development framework. In 2006, the Group changed from of their "sustainable development" to "corporate social responsibility". The following year, the Group began to combine their CSR and economic performance, as well as began articulating in more detail the global impact of their corporate social responsibility activities. In 2009, the Group dedicated a website to communicate the highlights of its annual report, and included its CSR activities. They also introduced the development of a CSR delegation to oversee their CSR policies and reporting. The Group used their 2011 CSR report to introduce their Responsibility Charter - BNP Paribas: Our Mission Our Responsibility. The purpose of this Charter was to announce to their internal and external stakeholders, as well as their shareholders their commitment to being a "Responsible Bank". Their Charter has helped to develop their current Group wide CSR strategy, which is based on 4 pillars – Environmental, Civic, Social, and Economic along with 12 commitments. It is through these commitments that Group has been able to establish a framework that is measurable in order for them to report the impacts that they have made to the global society.

TYPOLOGY OF CSR REPORTING AND CORPORATE GOVERNANCE MODELS

The USA and the UK share a common shareholder orientation, where the ultimate goal of listed companies is to create value for their shareholders.

France and Germany share a stakeholder orientation, where the interests of non-financial stakeholders (such as workers, suppliers, consumers, etc.) are allegedly part of business conduct.

USA	**short-term** oriented shareholder primacy
UK	**long-term** oriented shareholder primacy
FRANCE	**distant** stakeholder orientation
GERMANY	**close** stakeholders orientation

Given the main legislation for CSR reporting and Corporate Governance (CG) structures reviewed previously, we are now able to build a typology depending on whether the CSR reporting regime is stringent or non-stringent (horizontal axis), and on whether the CG structure is based on the shareholder, the stakeholder or the hybrid model (vertical axis).

	Shareholder model	Stakeholder model	New (integrated) model
Objective	Shareholder value	Stakeholder value	Social value
Localisation	Very active	Limited	Active
Shareholding	Dispersed	Concentrated, blockholders	With long-term institutional investors
Control	External, Market-based	Internal, Monitoring	Harmonized principles of governance (eg. OECD)
Horizon	Short term	Long term	Long term
Incentives	High powered financial incentives	Low powered financial incentives	Mix of financial and extra financial incentives
Boards	Dominated by shareholder representatives	Dominated by shareholders and labour	Diversified composition
CSR Policy	Only if compatible with financial return	Yes	Yes

The new model of corporate governance

CONCLUSION TOWARD A NEW MODEL OF GOVERNANCE AND PERFORMANCE

- We have emphasized the diversity of national trajectories regarding corporate governance and CSR.

- The rise of institutional investors, the growing importance of disclosure, and the 'comply or explain' principle as regulatory tools are of primary importance.

- Society requests transparency; traditional reporting and business as usual are no longer considered as an option.

- Driven by the transformation in a company's ownership, the acknowledgement of the limits in existing models of governance and performance, along with the rise of the CSR Movement, these factors will lead to a new model of corporate governance.

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In April 2013, the European Commission has published an amendment to the Fourth and Seventh Company Law Directive targeting the disclosure of non-financial and diversity information of certain large companies. The new proposal is now in the hands of the European Parliament and the Council.

The companies concerned by this legislation are large companies (and consolidated subsidiaries) with more than 500 employees and balance sheet total of 20 million Euros or net turnover of 40 million Euros. Target companies will have to include in their annual report a non-financial statement detailing the policies, results and risk-related aspects on environmental, social, human rights, anti-corruption and bribery issues.

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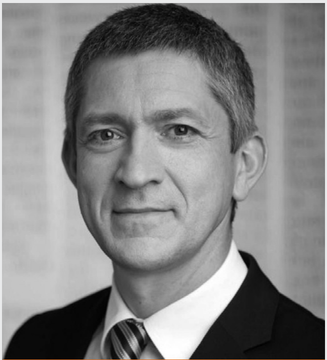
THE LUXEMBOURG LEADING NETWORK ON CSR



Christian Scharff
Président, IMS Luxembourg

" IMS Luxembourg (Institut pour le Mouvement Sociétal) is a business network that promotes Corporate Social Responsibility (CSR) in Luxembourg. The NPO was founded in April 2007 by six luxembourg companies: ArcelorMittal, AXA, BIL, KNEIP, MNKS et PwC Luxembourg, already well embedded in the policies of CSR.

IMS Luxembourg has currently 100 members, that represent more than 10% of the work force in Luxembourg. It is opened to all luxembourg company and our aim is to reassemble a large number of partners (public and private), as well as associations concerned with CSR. Our mission is to guide members in their CSR initiatives and give them tools, so they can develop their policies and carry out their projects.

Since its beginning, IMS Luxembourg has been a thought and exchange platform for CSR. Today, we guide our members in concrete projects that help them going through action (The Diversity Charter Lëtzebuerg, Part&Act : partnership between associations and companies, Sustainable purchaising, Governance and CSR and SMEs, CSR and territorie). "

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ILA
Institut Luxembourgeois
des Administrateurs

" The mission of ILA is to promote the profession of Directors by developing its members into highly qualified, effective and respected Directors. In parallel, it will promote best practices in Luxembourg in the field of Corporate Governance of companies and institutions by actively engaging with and contributing to those institutions and trade associations charged with the introduction, application and oversight of those Corporate Governance rules and practices. It will achieve this through high quality training, forum discussion, research, publications and conferences.
ILA aims to be not only the premier interlocutor in Luxembourg on issues affecting Directors but also to play an important role at the European level. "

IMS LUXEMBOURG
Inspiring More Sustainability

This study is a condensed version of a full study available on **www.imslux.lu**

Enterprise 2020
smart sustainable inclusive
www.csreurope.org

Printed in Luxembourg
ISBN 978-99959-821-1-9
November 2013

IMS Luxembourg is the national representative of CSR Europe for Luxembourg. CSR Europe is the leading European business network for Corporate Social Responsibility with around 70 multinational corporations and 34 national partner organisations as members.